CROSS SECTIONAL MOMENTS AND PORTFOLIO RETURNS: EVIDENCE FOR SELECT EMERGING MARKETS

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Empirical literature does not indicate a consensus on the relationship between idiosyncratic volatility and asset returns. Moreover the role of cross sectional higher order moments in predicting market returns is relatively unexplored. We study these areas for BRIICKS economies (Brazil, Russia, India, Indonesia, China, South Korea, and South Africa) and construct cross sectional variance of stock returns (CSV) as an alternative measure of idiosyncratic volatility (as suggested by Garcia, Garcia, & Martellini, 2011). This measure has the advantage of being easily calculated at any frequency. Further, it is not based on any model and is therefore free from parametric biases. Another advantage of this cross sectional measure is that it can be conveniently extended to higher order moments.

We find that the CSV measure is highly correlated with alternative measures constructed as variance of errors from the capital asset pricing model (CAPM) and the Fama French (FF) model. We check the role of CSV and higher order moments (cross sectional skewness (CSS) and cross sectional kurtosis (CSK)) in explaining market returns at monthly and daily frequency. We find that CSV has a significant positive relationship with market returns only in some sample countries. The relationship of CSS and CSK with future market returns is normally positive (CSK in India is an exception). Further, the results are stronger for the daily data compared to the monthly data, which is in line with Garcia et al. (2011).

We also check if CSV, CSS, and CSK contain any information which can be used by investors for constructing portfolios. Results show that there is no consistent relationship between CSV sensitivity and portfolio returns. Similar results are reported for CSK sensitivity sorted portfolios. More consistent results are obtained for the CSS measure. High CSS sensitivity sorted portfolios outperform low sensitivity sorted portfolios in five out of seven countries. The absolute risk premium is also generally higher for CSS sensitivity sorted portfolios. Further, asset pricing models explain portfolio returns satisfactorily, with some exceptions. On a risk adjusted basis, among the sample countries, South Africa offers the most profitable trading strategy based on CSS sorted portfolios. The study provides important implications for investment managers as well as researchers.

Reference

Garcia, R., Garcia, D. M., & Martellini, L. (2011). Idiosyncratic risk and the cross-section of stock returns. EDHEC Working Paper. <http://professoral.edhec.com/servlet/com.univ.collaboratif.utils.LectureFichiergw?ID_FICHIER=1328885973339>.

EXECUTIVE COMPENSATION AND FIRM PERFORMANCE: EVIDENCE FROM INDIAN FIRMS

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The problem of how best to compensate executives is a classic application of the principal–agent theory. While the literature on pay-performance has been largely focussed on the Anglo-Saxon economies, limited research has been carried out in the context of emerging markets. In the Indian context, studies focussing on the managerial labour market and executive compensation have been a recent phenomenon.

We examine the relationship between pay and performance from the year 2002 to 2012 for a sample of Indian listed firms. We employ the system—generalised methods of moments (GMM) estimator to account for the potential endogeneity (between pay and performance) problem in examining the pay-performance relationship among the sample firms. Thus, to the best of our knowledge, ours is an attempt for the first time to comprehensively examine the pay-performance relationship among Indian firms, using the wider firm level dataset. We report significant persistence in executive compensation among the sample firms. The persistence in the executive compensation exists even among the sub-samples of firms, classified based on size and ownership. Findings also suggest the existence of significant pay-performance relationship among the sample firms. However, when performance is measured using market based measures, we do not find pay-performance relationship among the sample firms. It may be argued that sample firms determine their executive compensation based on the accounting based measures of firm performance rather than market based measures. Further, we report the absence of pay-performance relationship among the business group affiliated firms, whereas their stand-alone counterparts report significant pay-performance relationship. Such an observation casts doubts over the performance based executive compensation practices of Indian business group affiliated firms. We also find that the pay-performance relationship is absent among the small sample firms, but the relationship is significant among the larger sample firms.